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Agenda Item 9a

June 13, 2011

TO: MEMBERS OF THE INVESTMENT COMMITTEE

- I. **SUBJECT:** Internal Equity Brokerage: Process and Results
- II. **PROGRAM:** Global Equity
- III. **RECOMMENDATION:** Information
- IV. **ANALYSIS:**

Introduction

For a number of years, the “per share” commissions paid for equity trade execution have been in decline. During this same time frame, the number of brokerage relationships utilized to execute CalPERS internal equity trading had been increasing, causing each relationship to become less financially significant for both parties. This resulted in an unsatisfactory situation for both CalPERS staff and the external brokers.

At the October 2008 Investment Committee meeting, Global Equity staff presented a set of modifications to establish a more rigorous process to evaluate its agency brokerage relationships and allocate trading activity. A significant attribute needed in the transformation of this process was a reduction in the number of trading relationships to both increase materiality and reduce operational risk. The objectives that reside at the center of the brokerage allocation process are:

- Best execution.
- Opportunity for diverse, emerging firms.

The assessment process is the creation of a partnership between CalPERS internal equity trading staff and Mosaic Investment Advisors (Mosaic). Mosaic's ongoing role in the process has several dimensions:

- Design and administration of a questionnaire to obtain information from a wide array of equity brokerage providers.

- Assessment and dialog with providers to understand their skills and explain the needs and objectives of CalPERS internal equity trading.
- Participation in the periodic assessment process.
- Advocacy on behalf of diverse, emerging firms.

This process is repeated semiannually and incorporates three dimensions that determine the categorization of each firm currently participating:

1. Execution quality – Results from actual trading activity relative to the established benchmarks and objectives.
2. Operational capability – Measurement of any operational issues with communication, execution or settlement of trading activity.
3. Additional value – Other resources such as technology, access to security offerings, relevant research capability, and ability to respond to requests for specific security or market information.

In the assessment process brokerage firms are assigned to one of three different pools:

1. Core – Those who demonstrate the most effective combination of attributes. A substantial amount of the trading activity is directed to this category to insure the business is material to both CalPERS and the brokerage firm.
2. Development – Firms that are executing a portion of CalPERS activity to provide information points and experience for both parties. These firms receive feedback to assist them in becoming “Core” participants.
3. Queue - Brokers that are interacting with Mosaic to understand their capabilities and attributes. These firms may join those executing CalPERS trading activity, as the assessment process removes some of the less effective participants, and creates the capacity for others to join.

Results

The process begun in 2008 has significantly changed the characteristics of the firms providing agency execution of equity trades. Brokerage firms that are owned by disabled veterans, minorities, or women are “targeted” for inclusion where their capabilities match CalPERS activity. Specific changes are:

- Reduction in the number of executing firms from 78 to 26, (a 67% reduction) and an increase in materiality.
- Improvement in all three attributes used in the assessment process.
- More representation for “targeted” firms as the number rose from 9 to 12. These firms now constitute 46% of the pool, up from 12%.
- The proportion of commission dollars accruing to “targeted” firms has increased 400%, growing from 11% of the total to 44%.

The improved efficacy of the brokerage assessment and allocation process derives from the participants’ recognition of CalPERS objectives and the assessment criteria. Each firm receives a rigorous and transparent evaluation of their results with explicit discussion of their strengths and weaknesses for all three evaluation criteria. These firms know that their results will determine whether they remain in the pool and the proportion of trading activity they receive.

Challenges

Many lessons have been learned by CalPERS staff and Mosaic as this process has evolved. Specific challenges include:

- With the brokerage roster substantially consolidated, effective rotation between the pools will be critical to future success.
- A degree of turnover must be maintained to allow for new firms to participate.
- The questionnaire employed in the process needs to be continuously modified to include additional data that will aid in broker selection.
- Communication with the brokerage community is essential to aid their understanding of the process and objectives, while reinforcing the knowledge that there is a single path to obtaining CalPERS equity trading activity.
- Improvement in the dialog held with participants.
- Greater efficiency in the data collection process.
- Extrapolation to external asset managers where appropriate and relevant.

Conclusion

The modifications in the process used to allocate internal equity trading activity have been successful. Execution quality has improved while increasing the representation of diverse firms. Challenges will continue to exist particularly since demand will continue to outstrip CalPERS capacity. This constraint

requires a transparent and structured process that focuses on the needed results, while forcing a degree of turnover to create opportunity.

V. STRATEGIC PLAN:

This item will further the following goals of CalPERS Strategic Plan:

- Goal VIII. Manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits and second, to minimize and stabilize contributions
- Goal IX. Achieve long-term, sustainable, risk adjusted returns.

VI. RESULTS/COSTS:

The cost of this process is the ongoing involvement of Mosaic to provide capabilities that are not core skill sets of CalPERS staff. This expense is estimated at approximately \$600,000 annually.

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